

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MIC:DET:TL-N-1143-00
GEGabriel

date:

to: Larry I. Walter
National Inventory Issue Specialist

from: Grant E. Gabriel
Michael E. Lueck
Counsels to National Inventory Issue Specialist

subject: [REDACTED]
Index Computation

This memorandum responds to your request for assistance on last-in first-out (LIFO) inventory issues applicable to the above-referenced taxpayer. Specifically, you requested us to opine as to whether [REDACTED]'s method of sampling and method of determining current-year cost comply with the requirements set forth in Treas. Reg. §§ 1.472-8(e)(1) and (2). The advice in this memorandum is subject to post-review in the National Office. Accordingly, please do not share this advice to the Exam Team until we receive National Office validation.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

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Under the circumstances described below, whether [REDACTED]'s method of determining its LIFO price index is permitted under Treas. Regs. §§ 1.472-8(e)(1) and (2).

CONCLUSION

No. [REDACTED]'s sampling technique does not satisfy the requirements of Treas. Reg. § 1.472-8(e)(1) because each item does not have a non-zero chance of selection. [REDACTED]'s use of the prior-year cumulative index to value current LIFO layers is contrary to the requirement to use current-year actual cost set forth in Treas. Reg. § 1.472-8(e)(2).

FACTS

[REDACTED] elected the dollar-value LIFO method for its taxable year beginning [REDACTED]. [REDACTED] elected an index method to determine current-year cost. Under its index method, [REDACTED] consistently sampled [REDACTED] to [REDACTED] percent of its items, while systematically excluding new items and small dollar items that comprised the remaining [REDACTED] percent of the current-cost of the pool inventory. For some pools, [REDACTED] did not sample any items.

[REDACTED] elected to determine current-year cost of items making up a pool by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition ("earliest acquisitions cost method"). In applying the earliest acquisitions cost method, [REDACTED] used the prior-year cumulative index to value a current-year layer.

[REDACTED] did not maintain books and records that would enable it to determine the base-year cost of the non-sampled portion of its inventory. The Examining Agent proposes that [REDACTED] file a request for change in method of accounting (Form 3115) to correct the improper methods prospectively. The request would include a change from the earliest acquisitions method to the most recent purchases method of determining current year cost. In addition, the request would include a change from the exclusion of certain segments from the computation of the pool index to a method giving each item in the pool a known, non-zero chance of selection in determining the pool index.

LAW

Section 446(a) of the Code provides taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 446(b) provides if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 472(a) allows a taxpayer to elect the LIFO inventory method. The use of the LIFO method, however, must be in accordance with the regulations, must be applied on a consistent basis, and must clearly reflect income.

Treas. Reg. § 1.472-2(h) provides that the records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in § 1.472-1; and such supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of § 472 and §§ 1.472-1 through 1.472-7.

Treas. Reg. § 1.472-3(d) provides whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. § 1.472-4 provides a taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

Treas. Reg. § 1.472-8(e)(1) provides a taxpayer may ordinarily use only the so-called "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. § 1.472-8(e)(2)(iv) provides if there is an increment for the year, the ratio of total current-year cost of the pool to the total base-year cost of the pool must be computed to determine the LIFO value of the increment.

DISCUSSION AND ANALYSIS

Section 1.472-8(e)(1) provides that, under an index method, the index is computed by double extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. In this case, [REDACTED]'s sampling method does not result in all items in the sample having a non-zero chance of selection. This is contrary to the position established in our Coordinated Issue Paper (CIP) entitled "Segment of Inventory Excluded from computation of the LIFO Index" (attached as Exhibit A). The CIP is predicated on the fact a "representative portion" must be based on sound and consistent statistical methods. Even though [REDACTED] samples a relatively high percentage of the items in some of its pools, the fact that the remaining portion of the pool has no chance of selection creates the potential for incorrect inflation rates to be assigned to these items. In addition, in some instances [REDACTED] does not sample any items of a pool. If some portion of the population has no chance of selection, the sampling technique does not represent the entire population with an acceptable level of confidence.

[REDACTED]'s use of the prior-year cumulative index is an improper way of determining the actual cost of acquisitions during the current year. Section 1.472-8(e)(2)(iv) requires the LIFO index to be based on the ratio of current-year cost to base-year cost. This necessarily requires costs from the current year to be used rather than the costs from the prior year. [REDACTED]'s use of the prior-year cumulative index is also expressly contrary to the position established in our Coordinated Issue Paper entitled "Earliest Acquisition Method" (Attached as Exhibit B).